

The ABCs of Risk Classification in Washington

**Determining Risk Classifications for
Workers' Compensation Coverage**



Preface

The Insurance Services Division of the Washington Department of Labor and Industries has produced *The ABCs of Classifications in Washington*:

- **For employers, service providers and other interested persons.**
- **As a logical explanation of government rules about Washington's workers' compensation classification system.**

The ABCs of Classifications in Washington does not represent or replace official administrative rules (WAC's) that govern the administration of the workers' compensation classification system in Washington State. This publication is intended to aid in the understanding of the classification system and how it affects your business. We believe our system and classification approach is the most cost effective and least burdensome for our customers.

This publication will be helpful if you have or are considering a business in Washington. It should also be helpful to service providers and others who want to expand their understanding of Washington's workers' compensation classification system.

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Why do we need a workers' compensation classification system?

Washington law (RCW 51.16.035) requires the Department of Labor and Industries (L&I) to have a classification system and rating plan. Since we have to charge employers something to cover their workers' compensation obligations, we need a classification system in order to provide fairness and to charge employers *based on their potential for loss*. As a non-profit insurance carrier, we need to collect only enough money (premium) to pay losses (claims costs).

How does the classification system work?

The workers' compensation classification system is a tool that we use to collect loss information for each industry we insure. We use this loss information to establish premium rates that employers in each industry will pay for their workers' compensation insurance. Our goal is to produce fair insurance rates that reflect the hazardous nature of each industry. Employers engaged in more hazardous industries such as logging will tend to pay higher insurance rates than employers engaged in retail store operations.

How does our classification plan compare to plans used by private insurance companies?

Although our classification approach is similar to the approach used by private insurance companies, our classification plan differs. We believe the classification plan used in our state should be tailored to reflect the type of industries found in our state. Classification plans used by private companies are generally based on businesses and industries common to the United States and not any specific state. We believe our classification plan is more responsive to the employers we insure because it mirrors the industries in our state.

How many classifications should we have?

Without a method of distinguishing the different potential for loss that diverse businesses have, all employers would be in the same classification. The total cost of claims would be divided equally between those businesses. This method would produce a *single average rate* that all businesses would be required to pay. The effect of a *single average rate* approach is that the low hazard businesses would subsidize high hazard businesses. Such an approach would produce a premium rate unfair to most businesses we insure.

The opposite of a *single average rate* approach would be to assign a separate classification to each business we insure. This approach would recognize the uniqueness of each of those businesses because each classification would precisely match a particular business. Disagreements over proper classifications would be eliminated. While each "*classification*" would be homogeneous, few would produce stable or affordable premium rates for employers and they would not produce statistically reliable data for rate making purposes.

How is our classification system designed?

We use a system of classifications, which are keyed to the businesses or industries of the employers we insure. Our system has over 300 classifications that price workers' compensation insurance at a reasonable charge so businesses pay premiums based on the degree of hazard their workers are exposed to. As required by RCW 51.16.035, our classification and rating system is based on recognized principles of workers' compensation insurance used by private insurance companies.

Do we assign classifications based on the nature of your business or on the occupations of workers in your business?

With few exceptions, we assign your business a *basic classification*, which is based on the nature of your business, rather than by the occupations, or operations of your individual workers. The premium rate for your basic classification reflects the duties and operations of all your workers. Having one basic classification assigned to cover all the operations makes record keeping and reporting simpler for you. (The exceptions to this approach are discussed later in this publication.)

If our classification system were based upon individual occupations, you would pay a lower rate for all your workers whose duties are considered low hazard, but you would pay a higher rate for all your workers who have duties that expose them to a greater hazard. The total premium you pay would not be decreased; it would only be redistributed and would require more record keeping on your part.

One of the major drawbacks to a classification plan based on occupation is that there is no common agreement or definition for each occupational title used by a business. Consider the occupational title "customer service representative". Many "customer service representatives" work in an office environment assisting customers by phone; some work on the sales floors of retail establishments; some load customers' vehicles in the yards of building material dealers; others service household appliances. Each of these types of workers is exposed to different work hazards; the only common thread is their occupational title and the fact that they work with customers. If we administered a classification system of this nature employers would be required to keep more detailed records. Our administrative costs would increase, as audits would become more complex and time consuming to perform. We also believe that there would be an increase of disputes related to record keeping. The added dispute resolution, extra burden of more detailed record keeping, and the added costs associated with our audits would result in higher premium rates.

How do we decide what classifications to assign to your business?

We need *enough* information about your business operations to give us a clear understanding so we can determine the *precise* nature of your business. Take, for example, a company that sells baked goods to retail customers. It is important to determine whether the business bakes the goods they are selling or if they are simply selling goods another business has baked. Once we have determined the precise nature of the business, we will review all the available

classifications to find the one that best describes the entire business. If the business has baked the products they

are selling, we would consider a bakery classification or maybe a restaurant classification. If the business simply sold baked goods that another business made, we might look at a retail store classification. In most cases, we will find a classification that specifically describes the business we are classifying.

To summarize, we will assign a single classification or several classifications, as applicable, which best describe your overall business operations. To determine which classification or classifications apply to your business, we will consider the wording of the basic classification as well as our list of general inclusions and the exception classifications.

To illustrate how we decide the classifications to assign to your business, picture the variety of delivery vans and trucks you encounter when driving on interstate highways. In this example, there is a company-owned truck delivering grocery items, a van that delivers parcels and packages, a moving van transporting household goods for a customer, and a common carrier company hauling goods from one state to another. Even though the drivers of these vehicles are performing similar duties at the time (hauling goods/driving on a freeway), we would not assign them the same classification. We would consider the overall operations of the businesses they work for and assign classifications based on the types of businesses. We learn that the truck delivering grocery items is owned by a retail grocery store and they were transporting goods from a central warehouse to one of their stores. We would look at classification 6402, which covers retail grocery stores. The wording of that classification does not require drivers to be reported in another classification so the grocery store classification would include the driver. Let's assume that the driver of the van delivering parcels and packages is an employee of a drug store. Drug stores are covered under classification 6406. The wording of classification 6406 requires that drivers be reported in classification 1101. Therefore, we would assign classification 1101 for the driver. Moving and storage companies are covered under classification 6907. Since classification 6907 does not exclude drivers, the driver would be reported in that classification. And, finally, we would assign the interstate/intrastate trucking classification 1102 to the common carrier trucking operation.

Does this same classification approach apply to building and construction contractors?

Yes. We use the same classification approach, but we modify it somewhat for contractors in the building and construction industry. We classify contractors by phase and type of construction since contractors do not always perform the same level of work on each job they contract to perform. For example, a contractor who builds and remodels private residences may frame the structure and work on no other phases of the project. On another job the same contractor may do only the interior finish carpentry. On still another job the contractor may install a wood deck or build a garden arbor. Each of these carpentry activities is covered under a different classification code. To ensure that contractor businesses receive the same treatment as other businesses, contractors are assigned classifications according to the phases and types of construction they contract to perform. Since some contractors specialize in one area of construction, such as plumbing, roofing, insulation, or electrical services, this classification approach mirrors that of non-contractor businesses. The policy of assigning several classifications to contractors engaged in multiple phases of construction may seem to be in conflict with the classification approach

used by non-construction businesses. A closer look reveals that we have simply used the *multiple enterprise* classification approach for contractors.

To assist in our classification assignment process, we have published a *Workers' Compensation Underwriting Guide*, which describes each of our classifications. This guide includes an alphabetical index of most businesses and industries in the State of Washington and a corresponding classification code. The alphabetical index is intended as a beginning point in determining the proper classification for a business. You may obtain a copy of this guide and index from us by calling **360-902-4817**.

How do we decide what classification to assign to your business if it is not specifically referenced in our classification plan?

Although we attempt to keep our classification plan updated, our current classification codes may not contain a specific reference to the type of business you operate. When this occurs, we follow much the same classification process as when a reference does exist. Assume you are the owner of a pen manufacturing business. We still need to determine the *precise* nature of your business so we would contact you for further information and learn:

- that you buy the ink stick or cartridges from another unrelated business
- that some of your pens have plastic housings and others have metal housings
- that you purchase all the plastic components from another unrelated business
- that you manufacture all of the small metal components at your plant
- that your metal manufacturing consists of metal stamping, using metal lighter than nine gauge, and extrusion processes
- that you also manufacture small boxes to package your pens
- that you operate a printing department for printing your company's logo and pen information on the boxes
- that, as a special service to customers, you will deliver their pens if they are within a sixty-mile radius of your plant.

To simplify our process we have grouped the approximately 300 classification codes into about thirty-eight smaller groupings. In the case of a pen manufacturer, we can eliminate the groups that deal with farming, gardening, logging, mining, food processing, textile goods, leather, wood products, stone products, chemicals, construction, stores, and services. We narrow our search to the group that covers metal goods manufacturing. Within the metal goods manufacturing group we have:

- classifications that deal with the fabrication of structural iron or steel beams used in construction;
- a classification that deals with the type of plate metal that is used in making storage tanks and wood stoves;

- light weight sheet metal works such as heating and ventilating duct work; and finally, a classification that covers light metal products such as fishing tackle, jewelry, and scientific instruments.

When we consider the weight of metal, the processes of manufacturing, and the end product, we conclude that classification 3602, which includes the manufacture of fishing tackle, scientific instruments, metal buttons, and jewelry, is the best classification applicable to a pen manufacturer.

Again, once we have determined your basic classification or classifications, we will review the classification description and assign exception classifications *if* appropriate. If your business performs operations that are excluded from your basic classification we will also assign classifications to cover those operations.

What types of classifications does our system have?

Our system has two types of classifications.

- Basic classifications
- Exception classifications

Most are *basic classifications* that generally describe a specific type of business operation or industry such as mechanical logging, sawmills, aircraft manufacturing, or restaurants.

Since a basic classification reflects *all the liability* (exposure to hazard) of a business or industry, it should be broad enough to cover all the operations and occupations that *normally* occur in a given business or industry. Some workers in a business are exposed to very little hazard, while others are exposed to greater hazard. A classification that covers the *nature of a business* can be described as having a *spectrum of hazard*. The classic example of a spectrum is a rainbow. Just as the various colors blend to form a rainbow, *all* the operations and occupations that are *common* to an industry are blended together and included in a basic classification. This, in turn, produces a rate for the industry that represents an *average* of the hazards common to that business or industry.

We have identified certain operations that, because they are common to most businesses or industries, are included within most basic classifications. We refer to these operations as *general inclusions*. They are *included* in basic classifications -- unless the language of a classification specifically excludes them. These operations are:

- Aircraft travel by employees, other than members of the flying crew.
- Commissaries and restaurants for the employers' employees. However, such operations, when operated in connection with construction, erection, lumbering, or mining, will be assigned classification 3905 - restaurants.

- Manufacture of containers, such as bags, barrels, bottles, boxes, cans, cartons, wooden pallets, or packing cases by employees of the employers for use in the employer's operations.
- Hospitals, medical facilities, or dispensaries operated by employers for their employees.
- Printing, lithography, or similar operations of the employer when used exclusively for their own products.
- Maintenance or ordinary repair of the employer's building or equipment when performed by employees of the employer.
- Pick up and delivery when done by employees of the employer in connection with the business of the employer.
- Sales of all products being manufactured by the employer.
- Warehousing, handling, packing, and shipping when done by employees of the employer in connection with the business of the employer.
- Testing or analytical laboratories when operated by employees of the employer in connection with the business of the employer.

Our approach of assigning classifications based on the nature of your business is reasonable for the bulk of your operations. However, we recognize that certain occupations have exceptional circumstances, so we have created *exception classifications* to cover those instances. Exception classifications are *usually* excluded from basic classifications.

- Some exception classifications allow employers to take advantage of a lower rate for their employees who are *never* exposed to the general work place hazards that their other employees are exposed to. The more common low hazard occupations include clerical office employees, certain sales personnel, and corporate officers. Other lower hazard occupations that are unusual for *most* industries include security guards at logging or construction sites, certain janitorial operations, and logging truck drivers who have no duties that are subject to a logging classification. The conditions that must be met to qualify for exception classifications are outlined in our general rules (Washington Administrative Code). If you have employees who meet these conditions or if you have questions about them your policy manager can assist you.
- Other *exception classifications* require a higher rate because they cover types of employment's that are *high hazard* and are *not* a common activity in most business operations. High hazard employments include aircraft, racing, and diving operations, entertainers, and new construction or alterations of buildings or structures. Details of these classifications are also outlined in our general rules (Washington Administrative Code).

Can your business have more than one classification?

Yes. There are two approaches to assigning classifications to your business:

- Single business (enterprise)
- Multiple business (enterprise)

In the *single enterprise approach* we assign the one basic classification that best describes your business operations. We will assign additional classifications when conditions require or warrant them. We will use classification 6406 to illustrate this approach. Classification 6406 covers a variety of retail stores such as book, trading card, office supply, or fabric stores. All manufacturing, outside installation, delivery, and lunch counter operations are excluded from classification 6406. If you operated a bookstore that had a lunch counter, espresso stand, or juice bar, we would assign classification 6406 to cover the bookstore activities. If the necessary conditions exist, we would also assign a restaurant classification since restaurant or lunch counter operations are excluded from classification 6406.

We use the *multiple enterprise approach* when you operate two or more separate, unrelated businesses. To illustrate this we will assume that you have a logging operation and also operate a small retail grocery store. There are several tests that we will use to determine whether more than one classification should be assigned for your various businesses. Our first test is to determine if it is common for persons engaged in a logging business to also operate a grocery store. The next test is to determine whether one business operation could or would continue to operate if the owner discontinued the other business operation. Other questions include: whether each business is conducted at separate locations; whether there are separate employees for each business; and whether separate books and records are kept for each business. If the answers to these questions are yes, we will assign several basic classifications to your businesses.

How does our classification system mirror the practices used by private insurance carriers in other states?

While we have tailored our system to reflect Washington's industries, we follow the same recognized insurance principles used by private carriers. Those principles are:

- *Mutually exclusive.* Our classifications are clearly defined so that each business or industry fits in only one classification.
- *Administrative ease:* Our record keeping requirements are simple and easy to follow.
- *Statistically credible.* By monitoring our classification plan, we ensure that enough hours are reported in each classification to provide a meaningful statistical base. A large enough statistical base helps avoid sudden large increases or decreases in rates and keeps them at the lowest possible level.

- *Homogeneous. (Pooling of risks with similar characteristics.)* Although it is rare that any two businesses are identical, our classification plan recognizes that similar businesses have similar exposures to occupational injury and disease. Employers with similar operations and exposures are grouped together so each classification includes common exposures and carries a rate that reflects those exposures. This method of grouping ensures that the overall cost of the workers' compensation system is distributed fairly among the businesses we insure.
- *Responsive to change.* Our classification plan is in a constant state of evolution to meet the needs of the businesses we insure. In the early 1970s, we had approximately 45 classifications. Today we have over 300 main classifications and around 1,200 sub classification codes to track losses. In some industries, the evolution is gradual, and no change to the classification itself is needed. We recognize that the wording used to describe a classification may not have kept up with the fashion of the day. However, as the industry conditions evolve because of modern equipment, new processes or materials, or changes in employment laws and safety standards, so does the experience upon which the rate is based. In other words, the changes in the experience that is used to develop premium rates *reflect* new developments in processes, equipment, and technology even though the wording in the classification is unchanged. We strive to keep our classification language current. Although it may seem we could just change the classification wording as we encounter changes in an industry, Washington law requires that we conduct public hearings before we make official changes to the rule. We do this as a public safeguard and to involve business in the change process.

It was only a few years ago that all logging in Washington State was done by chain saw. Today we see a large volume of our logging operations being performed by employees who operate processors, grapple skidders, harvesters, and loaders. Who would have imagined, at the turn of the century, a change of this magnitude?

The classification plan, through a series of main and sub-classifications, allowed us to track this information and create a new classification for this industry. These technological changes have resulted in premium reductions for employers engaged in mechanized logging operations by over seventy percent when compared to traditional logging methods. Another example of how classifications are ever evolving is in the area of manufacturing. The use of computer numeric controlled machinery has reduced the hazards of machine operators in many businesses, producing new classifications and reduced premium rates.

As technologies change or new industries develop, we receive requests from industry representatives for new classifications or for determination of proper classification assignments for the new processes. We evaluate requests to determine if there is a large enough group of employers to justify a new classification. Any classification must produce enough premium to cover losses. When processes become outdated because of new technologies, we will review the classification to see if it should be discontinued. In most cases, we will create a new classification to cover the new technology and retain the older classification for businesses that

use the older processes. In some cases, we will discontinue the classification and assign businesses reporting in the discontinued classification into another existing classification.

- *Encourages accident prevention and loss control.* By classifying employers by the nature of their business, each industry has the responsibility to control its own workers' compensation costs. Employers may belong to a trade association, which usually offers safety or risk management services. If such services result in fewer and less costly accidents, that improved experience will tend to lower the base rates for that industry. If our classification system were based upon the occupations or duties of employees, the success of a single industry's safety or risk management program would have little impact on its premium costs.

For example, many retail grocery stores employ meat cutters. If grocery stores wanted to reduce the frequency of injury to their meat cutters, they might develop a safety plan that focused on proper meat handling, lifting, and cutting. Assuming the safety program was successful and reduced the cost associated with meat cutter claims, the rate for grocery stores would go down. If, on the other hand, all meat cutters, including those who work for restaurants, grocery stores, and slaughter houses, reported under a single meat cutter classification, it is doubtful that the grocery stores' safety program would have any impact on the premium rates since grocery stores' meat cutters would represent only a small portion of that classification.

How do we determine rates for each classification?

Because we use the business or industry classification approach, *base rates* for each classification are developed based on the loss experience of all the businesses assigned to the classification. The base rate is the *average* price for all employers in the classification.

Do all employers in a classification pay the base rate?

In practice, only a few employers pay the *base rate*. Most employers pay a modified rate, which we call your *experience rate*. An experience rate is the base rate adjusted by your *experience factor*. It produces a premium rate higher or lower than the base rate for the classification. So, employers with few claims will pay less than employers in the same classification who have many claims. Experience rating encourages strong safety and accident prevention programs. Details of how experience rating affects your premium are outlined in our general rules (Washington Administrative Code). Your account manager can also answer questions about your individual experience factor.

How do we administer the classification system?

Because the classification system is the foundation for the pricing of workers' compensation, we believe that administration of the system is one of the most important responsibilities for us here at Labor and Industries. We use the information we collect on each classification ("its overall experience") to predict future premiums. If our underwriters, auditors, or the court system that hears classification appeals applied the classification plan differently to businesses with similar operations, the data used in setting rates for two classifications would be incorrect. The wrong

payroll hours and claim losses would be added to the experience of the incorrect classification and the correct classification would lack this exposure.

We approach our administration of the classification system in several ways.

- Our Employer Services Section receives a copy of each application for an industrial insurance account. Account managers, who underwrite the policies, review the information that you, the employer, have provided and assign a classification, or series of classifications, according to the type of business or businesses you have identified to us. The account managers will contact you if they need additional information. When your account manager opens your account, or when they change or assign additional classifications, they will send you a written notice explaining your classifications and how to report your workers.
- Every quarter we ask you if there have been any changes to your business operations. We provide space on the *Employer's Quarterly Report for Industrial Insurance* for you to provide this information to us. We have designed our program in such a way that it relies on your voluntary participation and communications with us. We find that it is more cost effective to operate in this fashion, but it places a large responsibility on you, our insured, to help us manage the classification plan and ensure that the premium rates you pay are equitable.

How do we verify information you have supplied to us?

We have several ways of validating the information we use in our rate setting process. If your classifications are correct, if claims of your injured workers are assigned to the correct classification, and if you have correctly reported your worker hours, the data we use for setting rates is valid.

- **Surveys:** A representative of our Classification Services Section may conduct an on-site inspection of your businesses work operations to:
 - observe your work processes, raw materials, and machinery or equipment to learn new developments in your industry,
 - verify that we have classified your business correctly,
 - answer any questions you may have about your classification assignments.
- **Audits:** A representative of our Field Audit Section may perform a more in-depth analysis of your reporting to:
 - verify that you have correctly reported your worker hours,
 - test our reporting rules and help us keep current with changes in record keeping practices,
 - answer questions you may have about your reporting.

Before conducting an audit of your business, our field auditor will notify you what years and quarters will be covered. After the audit, the auditor will share the findings with you and provide any needed explanations of reporting requirements.

We usually find that we have assigned your classifications correctly and that you have reported correctly. However, sometimes we need to make changes in your account.

- If we have assigned an incorrect classification to your business, our general practice is to apply the new classification retroactively if the reclassification results in a lower rate, and delay to a future quarter the assignment of a new classification if it results in a higher rate. (This practice assumes that you provide us with accurate information about your business operations when we assign classifications.)
- If you have reported hours incorrectly, we will either collect premium owed to us or give you a credit on your account.
- ***Review of claims:*** We review the accident reports of claims filed by your injured workers. If the description of the accident does not appear to fit within the classifications assigned to you your Policy Manager will contact you for further information to ensure that each industrial injury is assigned to the correct classification.

Where can you obtain more information?

By phone:

360-902-4817

By mail:

Employer Services – Classification Section
Insurance Services Division
Department of Labor and Industries
PO Box 44148
Olympia, WA 98504-4148

On the web:

www.LNI.wa.gov/insurance